



Washington, D.C. 20505
DIRECTORATE OF INTELLIGENCE

6 June 1985

China's Economy in 1984 and Prospects for Economic Reform in 1985

Summary

When judged on the basis of a 12-percent growth in GNP, China's economic performance in 1984 was the best worldwide. Throughout 1984, the "responsibility system" and associated reform measures contributed to impressive results in the countryside, as agricultural output increased by 14.5 percent over 1983. Industry, although planned to grow by only 5 percent, soared instead by 14 percent. Beijing is worried, nonetheless that last year's growth rate--especially the 18-percent pace in the fourth quarter--was too high and that the economy may become dangerously overheated. Longstanding energy, raw material, and transport bottlenecks have been exacerbated, while factory managers, taking advantage of loopholes and confusion surrounding newly enacted urban reforms, have engaged in widespread abuses, causing financial problems and inflationary pressure. Moreover, these problems have created a degree of political embarrassment for the reformers, who have been at pains to prove that economic reforms adopted in October did not cause recent difficulties. Although the enthusiastic pro-reform crescendo that peaked last year apparently has subsided somewhat, the reformers still maintain the initiative. In 1985 Beijing plans to implement several key economic reform measures--in both agriculture and industry--but the scope and pace of new policy initiatives may be more cautious. In addition, this year's reforms will be accompanied by measures--such as tightening the central bank's control over the supply of credit, hiking interest rates, and altering tax rates--specifically intended to prevent a recurrence of last year's problems. [redacted]

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This memorandum was prepared by the Domestic Policy Branch, China Division, Office of East Asian Analysis in response to a Treasury Department request. Questions and comments are welcome and should be directed to the Chief, Domestic Policy Branch, China Division, OEA [redacted]

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Agriculture--A Good Year in 1984 but Policy Changes Cloud 1985 Prospects

Last year, total agricultural output value--an official Chinese statistic that until 1985 included both agricultural production and the share of industrial output produced by village industry--grew 14.5 percent over 1983. Even with village industry excluded, agricultural output during 1984 registered an impressive 9.9-percent rate of growth. Although grain output was up by a relatively modest 5.1 percent, cotton production soared by 31.1 percent, sugar output grew by 18.9 percent, and edible oil production increased by 12.3 percent. In response to growing consumer demand--and leadership exhortations--for increased supply and more varied sources of protein-rich nonstaple foods, Chinese farmers also produced more meat (up 8.8 percent), milk (up 19.9 percent), and aquatic products (up 11 percent). [redacted]

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Reforms in the Chinese countryside since 1979 have succeeded in both boosting production and raising living standards to unprecedented levels. Giving farmers more direct control over production through the highly touted "responsibility system" has helped, but the 50-percent increase in procurement prices that Beijing has paid farmers since 1978 is also a significant factor. These price hikes have led, however, to mushrooming budget subsidies because Beijing refused to raise commensurately the retail prices of processed foods in urban markets. In an effort both to reduce the state's financial burden and to improve the efficiency of agricultural marketing, Beijing has now decided to revamp its agricultural procurement system and to allow market forces to operate more widely in the countryside. [redacted]

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Under the terms of Beijing's previous procurement system, the government promised to purchase virtually all agricultural output that farmers were willing to sell. The government will now purchase only the amount of farm output specified by contract. Consequently, Beijing will no longer pay a premium price (50 percent higher than the basic procurement price) for over-contract output and producers will be forced to market their output on the free market. To soften the blow to farmers, Beijing has retained a safety net: if the free market price of an over-contract staple farm good falls below the basic procurement price, the government has promised to buy all over-contract supplies of that good directly from the farmer at the higher price. [redacted]

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In addition to changing its procurement policy, the government has permitted farmers to market many nonstaple foodstuffs--such as fruits and vegetables--at floating prices in urban and rural free markets. The aim of this measure is twofold: to reduce government price subsidies, and to encourage farmers to increase supplies of nonstaple foods to the cities, which will ultimately benefit the urban consumer and the farmer. Reports from the provinces indicate that short-term prices already have risen sharply, however, causing considerable consumer complaints. The government has anticipated rising nonstaple food prices and has responded in cities with cost-of-living subsidies and, where necessary, by intervening in the market and selling produce at prices lower than those in the free market. It is difficult to predict with confidence what effect these new policies will have on agricultural output. Grain production probably will decline as peasants plant

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more acreage to cash crops. The major question is how far Beijing will let grain output slip before forcing farmers to plant more grain. [redacted]

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Industry--Explosive Growth Creates Strains; Balanced Growth and Cautious Reform Called for in 1985

Although planned to record a modest 5-percent rate of growth, China's total industrial output in 1984 rose by a remarkable 14 percent--15.9 percent if brigade and team industries are included. Premier Zhao told Secretary Baldrige that fourth-quarter 1984 growth was 18 percent and first-quarter 1985 industrial output rose by a staggering 23 percent. Beijing clearly is worried that these growth rates are too high and that the industrial sector is becoming dangerously overheated. Longstanding energy, raw material, and transport bottlenecks are being strained to the limit and factory managers have engaged in widespread abuses--such as unauthorized wage and bonus hikes--that have caused serious financial problems and generated considerable inflationary pressure. [redacted]

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China's light industry sector, which accounted for slightly less than half of total industrial output, turned out impressive quantities of various types of consumer durable goods, such as television sets, refrigerators, and the like. Due to the poor quality and low reliability of many of these products, however, Chinese consumers have displayed a reluctance to purchase non-namebrand commodities. The textile industry is becoming a major problem in the light industry sector. Last year, cloth production dropped by 10 percent, reflecting increased raw cotton prices for factories. Since the spring of 1983, when Beijing removed an input subsidy previously given to cotton textile factories, enterprise managers faced skyrocketing production costs and reacted by reducing the amount of cotton inputs they purchased. Despite the 30-percent increase in raw cotton production last year, we expect China's textile industry to continue growing very slowly. [redacted]

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In China's heavy industry sector, energy output increased at a rate faster than expected, but serious shortages continue to plague the economy. Overall energy output grew by 7.4 percent (measured in millions of tons of coal equivalent, MTCE), with coal and crude oil production both rising by 8 percent. We believe, however, that China will have difficulty sustaining this rate of growth, owing to the inevitable diminishing productivity of key onshore oilfields--such as Daqing--and continuing price and transportation problems for coal. Energy conservation (measured in MTCE) reportedly reached 2.6 percent of total energy output. Electrical output also grew steadily last year (up 6.6 percent), but hydropower declined by one percent. [redacted]

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Urban Reforms

Last year, China's leadership made a major decision to extend economic reforms to urban areas--trying to duplicate the success achieved in the countryside. The key to Beijing's new urban reform program is industrial price reform. Chinese industrial ex-factory prices have changed very little since the 1950s and currently reflect neither relative scarcities in the economy nor production costs. Most western economists have observed for several years

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that Chinese economic reform cannot be achieved until price reform is accomplished. Chinese reformers long have recognized the importance of price reform, but the political risks involved have made price reform a controversial issue among the leadership. After several years of debate, pressure for price reform noticeably increased during the first half of 1984. In late October 1984, the Central Committee met in plenary session to ratify the decision on urban reforms and announced formally that price reform was now one of the party's major goals for the next five years. [redacted]

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Although a crescendo of enthusiasm for price reform raised expectations among some Chinese and foreign observers that Beijing would make a dramatic policy move, the leadership has insisted that the pace of price reform will be cautious, starting with agricultural prices. Beijing has promised that urban living standards will not fall as a result of price hikes and announced that a major wage reform move will take place in July. China's leading price official recently told journalists in Beijing that three major price policy measures will be adopted in 1985:

- Government procurement methods and prices for staple farm goods were changed effective 1 January 1985;
- Market forces will be allowed to determine the prices of pork in urban markets, but city dwellers will be given food subsidies to cover increased living costs; and
- Short-haul railway fees will be raised during the first half of this year.

Beijing has also implemented various other price reform measures, such as permitting prices of fruits, vegetables, and other nonstaple foodstuffs as well as of certain consumer durable goods to float in free markets, reducing the number of commodities regulated by the state plan, and attempting to link prices to quality. [redacted]

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Beijing recognizes that the Chinese industrial system needs to carry out other reform policies in addition to price reform. Sustained long-term economic growth can only be achieved if efficiency is improved and longstanding bottlenecks are removed. Beijing aims to accomplish this through such policies as increasing the economic decisionmaking authority of factory managers, giving them more authority over marketing their products, reinvesting their profits, and hiring and firing their workers. [redacted]

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Beijing has encountered problems in the process, however. Productivity gains have consistently lagged behind gains in wages and bonus payments, and increased enterprise autonomy has led to wasteful, redundant capital investment as well as to other abuses. Last year's urban reform decision--with its major focus on price reform--made urban dwellers especially fearful of imminent price hikes. Enterprise managers came under considerable pressure by workers to raise wages and bonus payments late in the year. Consequently, managers scrambled to borrow money from the banking system to pay for increased wages and bonus payments, causing a surge in the money supply and exacerbating China's financial strains. Inflationary pressures rose as bank loans nationwide reportedly grew by almost 30 percent and wages

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and bonuses by nearly 20 percent. Although we have not yet received complete data, available reports suggest that the trend set during the final quarter of 1984 continued during the first quarter of 1985. [redacted]

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Prospects

The leadership recognizes the dangers inherent in an overheated economy and has criticized the "unhealthy" tendency of allowing enterprise managers to expand production blindly, irrespective of supplies of inputs or demand for outputs. Senior Chinese officials and authoritative press commentaries have called for slower, more balanced economic growth, coupled with a redoubling of efforts to cut production costs and boost efficiency. Planning chief Song Ping, at the recently concluded National People's Congress session, reported that China's industrial output during 1985 is planned to grow by a relatively modest 8 percent and agriculture by 6 percent. [redacted]

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In an apparent effort to straighten out the ailing financial situation, Beijing appointed Chen Muhsa--former foreign trade minister and believed to be a strong proponent of exercising central control over subordinate economic units--to head the Chinese central bank. Chen has already exerted her authority over the banking system by imposing strict controls over the use of foreign exchange and by tightening the central bank's control over provincial branches. The bank reportedly will also exercise greater control by monitoring the wage funds of state-owned enterprises and by making it more difficult for enterprises to borrow funds from the bank. A senior Chinese economic official recently reported that the State Council has signed off on a new set of loan regulations that gives banks written authority to take over the pledged assets of any enterprises unwilling or unable to repay loans. [redacted]

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The reformers within the leadership have claimed--not convincingly in our view--that the problems associated with last year's too rapid economic growth were not caused by economic reform policies. They have been put on the defensive by the development of these problems and must be mindful of political opposition and criticism as they move forward with such controversial reform measures as price and wage reforms. In our view, however, the reformers still maintain the initiative and probably will be able to implement several key economic reform measures--this year in both agriculture and industry. These reforms will be accompanied by measures, such as tightening the central bank's control over the credit supply, which are designed specifically to prevent a recurrence of last year's abuses. [redacted]

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SUBJECT: China's Economy in 1984 and Prospects for Economic Reform in 1985

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(6 June 1985)